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State-owned Development Banks in Micro-finance

In recent years, micro-finance has gained growing recognition as an effective tool in improving the quality of life and living standards of very poor people. This recognition has piqued the enthusiasm of government officials in various countries to reform existing state-owned development finance institutions (Brazil, India, Tanzania) or to create new ones (Vietnam) to carry out micro-finance operations. The fact that one of the world's leading micro-finance institutions (MFIs), Bank Rakyat Indonesia (BRI), is a state-owned bank, often fuels this enthusiasm. It is important to note, however, that BRI's success as a micro-finance intermediary is an anomaly. The vast majority of successful MFIs are private, non-government entities that run on sound business principles.

The well-intentioned objective of state-owned development finance institutions--reaching the neediest people-- is too often subjected to political influences. Politicized mandates place undue emphasis on credit outflows over recovery. Poor lending practices such as, weak borrower selection criteria, little or no monitoring, and subsidized interest rates weaken the state-owned institutions financially and make them continually dependent on government or external donor funds. In short, the intent is not to establish a sustainable financial institution that will continue to provide a stream of services to the poor over the long-term, but to create credit disbursement channels.

BRI is one of very few state-owned institutions that overcame the problems that typically afflict them. It underwent considerable transformation at a significant cost to become a politically autonomous, client-oriented, well-managed, and profitable institution. The transformation process involved total commitment from the very highest levels of the Indonesian government, including the Ministry of Finance and the Central Bank. It involved acknowledging the failure of populist, subsidized credit schemes and changing nearly every aspect of BRI's village banking operations. Most importantly, the transformation took place within the context of broader financial sector reform that divested the state's control over the banking system.

This note seeks to inform policymakers and other government officials about the process of transformation of BRI's unit *desa* (or village banking) system, and identify key factors that led to the birth of a successful micro-finance institution. It argues that in the absence of these factors, the efficacy of reform for state-owned development finance institutions will be severely limited.

Bank Rakyat Indonesia (BRI)

After gaining independence in 1946, the government of Indonesia created five state-owned commercial banks, each with a separate mandate. BRI came into being in 1950 with the merger of two older state banks: Bank Prekreditan Rakyat (established in 1895) and the Algemeene

Volkscredietbank (created in 1934). BRI's predecessors were credit and savings institutions that catered to middle-class Indonesians, particularly in rural areas. Under the new government, BRI's purpose was to provide rural banking services with an emphasis on the promotion of agricultural development.

Today, BRI is one of the largest banks in Indonesia with a country-wide network of 325 branch offices; 3,595 unit *desas*; and US$12 billion in assets by the end of 1996 (GTZ, 1997). It provides a broad range of services: corporate banking, commercial banking, and micro-finance. In recent years, BRI's micro-finance operation, also known as unit *desa* system, has gained attention and praise as a leading micro-finance provider. It was not always so.

From BIMAS...

During the Seventies, the government of Indonesia declared self-sufficiency in rice production as one of the national goals as a way to improve rural living standards and incomes, and reduce the nation's dependence on rice imports. In 1973, the government introduced BIMAS (*Bimbigan Massal* or Mass Guidance), an agricultural extension service and credit program to encourage farmers to use new technologies and inputs in rice production[1]. BIMAS channeled subsidized government credit, tied to purchasing various inputs such as improved seeds, fertilizers, and pesticides, to rice farmers in rural Indonesia.

Given its mandate, BRI undertook implementation of the credit program under BIMAS. Unit desas were established at the village-level to operate as retail "windows" of the BRI district-level branch offices. Each unit *desa* served 18 villages on average and had four staff members: a unit chief, a credit officer, a book-keeper, and a cashier.

Although a number of factors contributed to the failure of the BIMAS credit program, three characteristics sealed its fate from the start.

Lack of autonomy. Unit *desa* staff had little control over their operations. For example, although desa staff made loans and collected repayments, they had no authority over selection and approval of borrowers. Officials in the Department of Agriculture and other local government agencies, under orders to achieve certain annual targets, carried out this job. In other words, the responsibilities for loan approval and loan collection rested with different individuals, thus holding no one responsible for the quality of loans made and the repayment[2]. This situation, combined with the pressure to achieve mandated targets, led to a problem of arrears that became very severe after a series of crop failures (Table 1).

Table 1: BIMAS lending operations
(selected years)

Period	Amount lent* (millions of nominal US$)	Number of Loans (millions)	Arrears rate (Unrecovered Amt./Amt. lent)
1973	42.4	2.3	5.28%
1976	186.7	3.4	10.57%
1980	80.6	1.6	14.54%
1983	61.9	1.2	33.28%

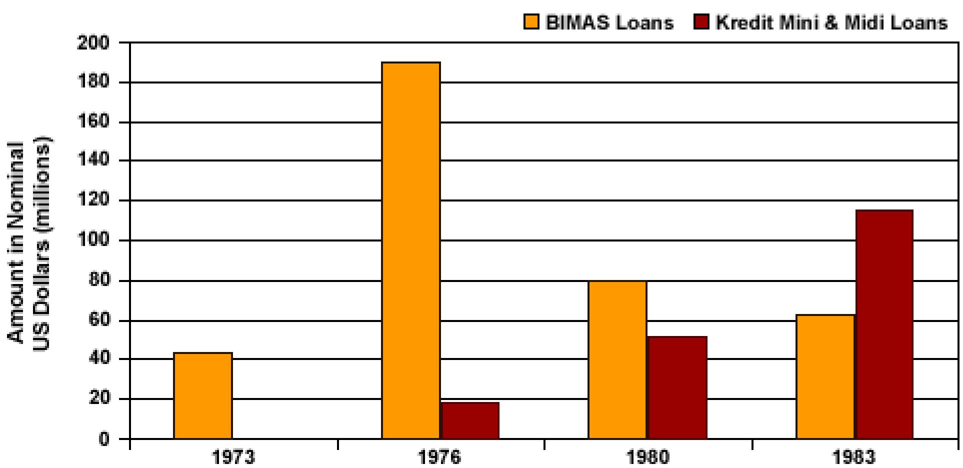
*** Total lending for wet and dry seasons**
Source: **Robinson, 1996**

Low interest rates on loans and deposits: The interest rates on BIMAS loans, fixed at 12 percent a year, was well below the inflation rate at that time (32% in 1973 and 40% in 1974). The deposit rate on the savings scheme was 15 percent. The low interest rates and small spread between the lending and deposit rates had three consequences. First, cheap loans attracted rich farmers to BIMAS that effectively blocked participation by poorer farmers and encouraged corruption. Second, lending and deposit activity did not generate adequate revenue to cover operating expenses, and the unit desa system began incurring large operating deficits that had to be covered by the government. For example, the administrative subsidy provided to the unit desas increased from US$4 million in 1976 to US$24 million in 1983 (Robinson, 1996). And finally, low interest rates on savings and weak design of the savings scheme failed to attract enough deposits and kept the unit desas dependent on government allocations for loanable funds year after year.

No financial accountability: Because the unit desas operated as a "window" to the district-level branch office, they did not maintain complete financial statements. Instead, they kept partial records that were incorporated into the financial statements of the district-level branch offices. The inability to track the performance of the individual units removed all financial accountability from the system.

In 1974, BRI's management made an attempt to move away from lending-under-mandate to a more customer-oriented service. Two new non-agricultural loan products, Kredit Mini and Kredit Midi, were introduced. They were not tied to any input packages; moreover, the staff of the unit desa had a greater role in loan approvals. But these loans still carried loan ceilings, government-determined borrower selection criteria, and mandated interest rates of 12 percent a year. Kredit Mini and Kredit Midi enjoyed more popularity than BIMAS loans and a better repayment record, but they were unable to offset the steep decline in BIMAS lending (Figure 1).

Figure 1: Total Lending



Not surprisingly, the combination of decreased lending activity, non-recovery of over one-third of the money being lent out, and declining revenues, resulted in mounting losses that made the unit *desa* system increasingly burdensome. During the early Eighties, lower revenues from oil exports reduced a major source of funds that had kept the unit *desa* operations going thus far.

...To the new Units Desas

The transformation of the unit *desa* system took place within the context of overall financial sector deregulation. In June 1983, the government of Indonesia suspended ceilings on loans, removed controls on interest rates for both deposits and loans, and prioritized savings mobilization. These changes provided an opportunity for BRI's management to explore new services and products.

With the full support of the Ministry of Finance and the Central Bank of Indonesia, BRI's management completely revamped the unit *desa* operations, including the services they offered.

- Organizationally, the position of President-Director, solely responsible for the unit *desa* banking system, was created at BRI's head office. This appointment accorded importance and attention to the unit *desa* system at the head office level. It also de-politicized decision-making and placed responsibility for the reform and subsequent performance of the unit *desas* in the hands of BRI's management.
- Structurally, unit *desas* separated from the district-level branch offices into autonomous financial entities. Each unit *desa* now prepared its own financial statements that allowed management to identify clearly the financial health of the unit. Each unit became a separate profit center and reconfigured its book-keeping and accounting system to reflect this change. For example, each unit *desa* prepared an individual balance sheet that reflected a loan loss reserve based on anticipated delinquencies, and a proportion of the government grants received as equity.
- District-level branch offices now supervised the unit *desas* (for which they received a service fee from the units) and managed liquidity between the units under their jurisdiction. The income statement of the unit *desa* recorded transactions such as interest paid on excess funds borrowed from the district-level branch offices to meet liquidity needs, and interest received on any excess liquidity maintained as deposits with the branch office.
- Staff accountability became closely associated with the performance of the unit *desas*. Direct responsibility for loan approvals and repayments rested with unit *desa* staff, particularly loan officers. The unit's performance guided staff recruitment and incentives. For example, an incentive bonus that distributed 10 percent of a unit *desa's* annual profits among its staff was introduced.
- Internal supervision and audit capacities were also strengthened. The number of internal supervisors/auditors increased from one per six unit *desas* to one per four. A standard audit manual provided simple and clear guidelines on supervision rules. Most importantly perhaps, supervisors, auditors, and unit *desa* managers and staff underwent a periodic training program, over three years, on reporting and supervision techniques. Greater supervision led to early detection of problems and early remedy.

The unit *desas*' products changed along with their structure and organization. New products were designed to meet the needs of the clientele and promote profitability. The first and most fundamental problem with the BIMAS loans was that they were too cheap. Low interest rates had blocked outreach of these services to the poor, led to corruption, and resulted in huge operating losses.

- Starting in 1984, the unit *desas* introduced two new loan products - working capital loans and investment capital loans -- under a new lending scheme called KUPEDES. The term for working capital loans ranged from three months to two years, and the investment loans had a maximum term of three years. The nominal interest rates equaled 1.5 percent (flat) a month and 1 percent a month (flat) respectively[3]. A penalty payment of 0.5 percent a month of the loan amount was imposed on all late payments.

The higher interest rate on KUPEDES loans screened out wealthier farmers who could obtain cheaper loans elsewhere. Borrowers had flexibility to use loans for their own purposes as long as they could prove their ability to repay the loan. This feature made the KUPEDES loans very popular. Within one year, by of December 1984, the units had made 639,000 KUPEDES loans totaling US$166 million. (Patten and Rosengard, 1991)

- On the savings side, both staff and management realized that savings was a potential (and in the case of Indonesia, a relatively cheap) source of funds that would effectively reduce the dependence of the unit *desas* on the largesse of the government. The unit *desas* marketed the existing savings scheme, TABANAS, aggressively and piloted a new savings scheme, SIMPEDES, in 1984. The needs of savers in rural Indonesia with respect to convenience, liquidity, and returns determined the terms, withdrawal facility, and interest rates for SIMPEDES products. After almost two years of design and experimentation, SIMPEDES was introduced nation-wide.

The bold steps of the reform effort yielded dramatic results. By 1986, the unit *desa* system turned from chronic loss-maker into a profit-making entity; a performance that has been maintained until today. In 1996, net income before taxes as a proportion of average earning assets - adjusted return on assets - stood at 5.5 percent. As of December 1996, the unit *desas* had 2.5 million loans outstanding with a total value of US$1.7 billion. The units also held nearly 16 million savings accounts that totaled US$2.6 billion. The average loan balance outstanding (US$680) represents 65 percent of annual per capita income and the average savings balance (US$163) roughly 16 percent, indicating that the unit *desas* serve poor Indonesian households. In addition, BRI supervises and funds the village sub-units (BKDs), where the minimum loan size is US$20.

Conclusion

What factors made the crucial difference between a successful transformation effort and a failed one? In broad strokes, they are as follows:

1. Stable macro-economic environment;
2. Strong leadership within BRI to steer the reform effort with unwavering political support from the government of Indonesia;
3. Considerable and prolonged backing in financial and human resources from the government and external agencies;
4. Liberal financial sector policy that allowed BRI to design its own products and price them according to cost-recovery principles;
5. Complete operational autonomy for the unit desas without any government mandates on reaching "lending targets" or population groups;
6. Large investment in professionalizing the human resource base through staff training, merit-based recruitment, and performance incentives; and
7. Clear and transparent financial reporting and accountability.

Of the elements listed above, two are critical: strong political support and financial and human capital. In the case of BRI, the transformation took place within the broader context of devolving the government's control of the financial sector. As a result, it faced few political difficulties. In other countries, political opposition to reforming state-owned development banks, particularly on issues such as removal of interest rate subsidies and rigid targeting of certain population groups as beneficiaries, can prove insurmountable.

The Indonesian government also invested considerable resources to cover operating deficits of the units (until they became profitable) and the costs of staff training, external advisors, and other forms of technical assistance during the transition. Moreover, it also received significant support from external agencies.

The case of BRI's unit *desa* system illustrates that, like other successful MFIs, a state-owned bank can achieve the goal of reaching the poor sustainably, so long as it operates under the same best practice principles. Government officials in other countries considering similar transformations should assure themselves that these principles can be implemented before launching an extensive reform effort. Above all, they should not overlook the critical role of the state in formulating sound financial sector policies that create an enabling environment and an even playing field for all actors (NGOs, village banks, credit unions, cooperatives, and government banks) to provide micro-finance services.

This note was prepared by Joyita Mukherjee, Program Analyst, CGAP Secretariat.

[1] It should be noted that the BIMAS scheme introduced in 1973 followed other failed rice intensification efforts during the 1960s also known as BIMAS. For a fuller discussion on earlier BIMAS efforts and establishment of Unit Desas, see Chapter Seven in The MicroFinance Revolution: Sustainable Banking for the Poor, by Marguerite Robinson (manuscript).
[2] Moreover, the government of Indonesia assumed 75 percent of the risk on BIMAS loans.
[3] On a declining balance, these rates are equivalent to 31.2% a year on working capital loans and 20.4% a year on investment capital loans for a one-year loan. The inflation rate in 1984 was 10 percent and has dropped to single digits since (Patten and Rosengard, 1991).

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